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# FOXES AND HEN HOUSES?: PERSONAL TRADING BY MUTUAL FUND MANAGERS

EDWARD B. ROCK\*

## INTRODUCTION

America's money is managed by professionals.<sup>1</sup> In this "fourth stage of capitalism,"<sup>2</sup> ensuring that those who manage our money do so in our interests becomes the critical question. This Article examines that question by focusing on the regulation of the personal trading activities of the managers of tomorrow's dominant institutional investor, mutual funds.

Institutional investors are a varied group—public and private pension funds, life insurance companies, commercial bank trust departments, charitable trusts and mutual funds. An unanticipated consequence of the Employee Retirement Income Security Act's ("ERISA") full funding requirement,<sup>3</sup> only now becoming clear, is that mutual funds are and will continue growing at the expense of traditional pension funds.<sup>4</sup> ERISA's requirement that pension liabilities be fully funded<sup>5</sup> has had the effect of driving money away from traditional defined benefit pension plans<sup>6</sup>

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1. The largest money management firm, Fidelity, now manages over \$275 billion in assets. *America's Top 300 Money Managers*, INSTITUTIONAL INVESTOR, July 1994, at 113.

2. ROBERT C. CLARK, *The Four Stages of Capitalism: Reflections on Investment Management Treaties*, 94 HARV. L. REV. 561 (1981) (reviewing TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS* (1978) and HARVEY E. BINES, *THE LAW OF INVESTMENT MANAGEMENT* (1978)).

3. ERISA §§ 301-06, 29 U.S.C. §§ 1081-86 (1994).

4. While a substantial amount of work has been done on the regulation of money managers, see generally TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS* (1978), the most recent discussions of institutional investors have focused largely on pension funds. See, e.g., Bernard Black, *Agents Watching Agents: The Premise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

5. ERISA §§ 301-06, 29 U.S.C. §§ 1081-86 (1994).

6. A defined benefit pension plan is one where the employing firm promises an employee a certain pension (usually a percentage of terminal salary) upon retirement. The investment risk in such

towards defined contribution plans.<sup>7</sup> Almost all of this defined contribution plan money flows into mutual funds, explaining the large growth in mutual fund investing. According to one recent estimate, twenty-seven percent of all U.S. households—almost 40 million people—have more than \$2 trillion invested in mutual funds.<sup>8</sup>

Now, against this background, come revelations of questionable behavior by mutual fund managers. Patricia Ostrander, a portfolio manager for Fidelity, was convicted of accepting an invitation to acquire valuable warrants from Drexel Burnham Lambert, after causing her fund to buy Drexel junk bonds.<sup>9</sup> John Kaweske, a successful and high profile money manager at the Invesco fund group, was fired for failing to report his personal trades to the mutual fund company,<sup>10</sup> and has now been charged by the SEC with misusing his professional position to benefit himself and others close to him.<sup>11</sup> Most recently, John Wallace, a top Oppenheimer fund manager, was fined \$20,000 for failing to report thirteen personal trades.<sup>12</sup>

In the wake of Kaweske's firing, it appeared that personal trading by fund managers was widespread. Some claimed that "[b]etter managers can earn as much trading for themselves as they are paid by the company to manage other people's money."<sup>13</sup> And these managers are already well paid.<sup>14</sup>

Personal trading by fund managers became, for a while at least, the issue

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a plan is borne by the employing firm.

7. A defined contribution plan is one where the employing firm's commitment is limited to a defined contribution. In this type of plan, which is fully funded *ab initio*, the employee bears the investment risk.

8. Patrick Harveson, *Fund Managers Face Private Trading Curbs: Protecting U.S. Investors*, FIN. TIMES, Feb. 24, 1994, at 6.

9. Ronald Sullivan, *Fund Manager Convicted of Taking Milken Bribes*, N.Y. TIMES, July 29, 1992, at D1.

10. See Sara Calian, *Kaweske Denies Misusing Position as Fund Manager*, WALL ST. J., May 18, 1995, at C13.

11. SEC v. Kaweske, No. 14399, 1995 SEC LEXIS 330, at \*1 (D. Colo. Feb. 6, 1995); see also *Former Invesco Fund Manager Charged in Fraud Scheme*, SEC ANNOUNCES, 27 SEC. REG. & L. REP. 249 (Feb. 10, 1995).

12. Robert McGough & Sara Calian, *Oppenheimer Management Fund's Head Is Fined by SEC for Personal Trades*, WALL ST. J., Mar. 1, 1995, at A6.

13. Brett D. Fromson, *Fund Managers' Own Trades Termed a Potential Conflict; Biggest Mutual Fund Firm Tightens Rules*, WASH. POST, Jan. 11, 1994, at A1.

14. At Fidelity, a manager of a fund with \$1 billion in assets is said to earn between \$600,000 and \$2.5 million in salary and bonuses. Fromson, *supra* note 13, at A1.

of the day.<sup>15</sup> In a letter to the SEC, Congress expressed its concern that personal trading presented a serious problem.<sup>16</sup> In response, the SEC opened an investigation, requested information on the private trading of thirty mutual funds, and eventually issued a report addressing the problem.<sup>17</sup> The Investment Company Institute (the "ICI"), the mutual fund trade group, responded to the furor by forming a blue ribbon advisory group that issued its own report and made recommendations in advance of the SEC report.<sup>18</sup> The chief concern, said many, was the protection of investors and the protection of the integrity of the mutual fund market.<sup>19</sup> Investors will cease to buy mutual funds, some worried, unless they are reassured that the market is fair—and private trading by fund managers undermines that perception.

The controversy over private trading by money managers, which is important in its own right, provides the perfect context for examining the larger set of issues relating to the regulation of money managers. Private trading by fund managers and the public outcry following revelations of impropriety are typical of a host of tempests that will arise in the future, and therefore demand close scrutiny now.

In this Article, I examine the regulation of personal trading by money

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15. See, e.g., Ronald Campbell, *Portfolio Pirates Pillage Mutual Funds*, ARIZ. REPUBLIC, June 4, 1994, at C1; Susan Antilla, *Money Managers Who Cross the Line*, N.Y. TIMES, Jan. 16, 1994, at C13.

16. Letter from Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Rep., to Arthur J. Levitt, Jr., Chairman, SEC (Jan. 11, 1994), cited in INVESTMENT CO. INST., REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING 2-3 (May 9, 1994) [hereinafter ICI REPORT].

17. Letter from Arthur J. Levitt, Jr., Chairman, SEC, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Rep. (Feb. 9, 1994), cited in ICI REPORT, *supra* note 16, at 2-3. See also, Albert B. Crenshaw, *SEC Looks at Fund Managers; Inquiry is Focusing on Personal Trading*, WASH. POST, Feb. 11, 1994, at E1; DIVISION OF INV. MANAGEMENT, U.S. SEC. & EXCH. COMM'N, PERSONAL INVESTMENT ACTIVITIES OF INVESTMENT COMPANY PERSONNEL: DIVISION OF INVESTMENT MANAGEMENT (Sept. 1994) [hereinafter SEC REPORT].

18. ICI REPORT, *supra* note 16.

19. See, e.g., Steve Bailey & Aaron Zitner, *Mutual Fund Managers Come Under Scrutiny*, B. GLOBE, Jan. 16, 1994, at A1 (quoting J. Carter Beese, Jr., an SEC commissioner, saying that the real concern is not the violation, but the deterioration of trust which may cause the public to lose confidence in the industry as a whole). See *infra* note 106 and accompanying text. See also Stan Hinden, *Proposed Personal Trading Limits Have Funds and Managers on Edge*, WASH. POST, Feb. 23, 1994, at F3 (reporting SEC Commissioner Richard Y. Roberts' belief that a ban on personal trading may help preserve the trust and confidence which is critical to the success of mutual funds); Tom Petrino, *Hard Questions for Fund Industry*, CHI. SUN-TIMES, Jan. 18, 1994, at 48 (suggesting that the small investor needs to feel confident that mutual fund managers differ from the "market crooks" of the 1980's and that fund managers will provide a "square deal").

managers as a vehicle for better understanding the bases and strategies for regulating money managers in general. In Part I, after briefly describing the organizational and regulatory frameworks of the mutual fund industry, I describe the regulations governing personal trading by money managers. In Part II, I describe the similarities and differences in the "codes of ethics" adopted by firms to regulate personal trading. In Part III, I examine the private incentives facing both fund managers and their employers, as well as the potential harm facing investors. I then consider the kind of regulation that would be appropriate in light of the nature of the potential harm. In Part IV, I analyze the ICI Advisory Committee's recommendations, and then turn to the SEC's more modest proposals in Part V.

## I. THE LEGAL FRAMEWORK

### A. *A Brief Account of the Structure of Mutual Funds*

Mutual funds have a distinctive organizational form that differs from most other corporations. Mutual funds, or, in the terms used in the relevant statutes, "investment companies," are companies that invest in securities.<sup>20</sup> Typically, Fund X is a corporation organized by Investment Adviser Firm Y which manages Fund X for a fee that is usually a percentage of assets under management. Having organized Fund X, Adviser Y enters into a management contract with X, selling shares of X to the public—sometimes directly, sometimes through brokers. Mutual fund investors are thus shareholders of Fund X who depend on the performance of Adviser Y for their returns. Often, Adviser Y organizes a variety of funds and distributes their shares through a common, wholly-owned distributor. In such cases, the groups of funds are referred to as "mutual fund complexes."<sup>21</sup> All of the best known names in the mutual fund industry are fund complexes: Fidelity Investments, Vanguard, Oppenheimer, and T. Rowe Price, among others.

Because of the conflict of interest between Adviser Y and the shareholders of Fund X, the Investment Company Act ("ICA")<sup>22</sup> mandates a number of governance devices. First, at least forty percent of the directors

20. Investment Company Act § 3(a), 15 U.S.C. § 80a-3(a) (1988) [hereinafter ICA].

21. See, e.g., Donald W. Glazer, *A Study of Mutual Fund Complexes*, 119 U. PA. L. REV. 205, 206-34 (1970).

22. Investment Company Act of 1940, Pub. L. No. 103-465 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64 (1994)) [hereinafter ICA].



(or trustees) of an investment company must be disinterested.<sup>23</sup> Second, the advisory contracts between Fund X and Adviser Y must be in writing and approved by a vote of a majority of outstanding shares and by a majority of the disinterested directors of Fund X.<sup>24</sup>

How Adviser Y provides its investment advice to Fund X varies. In some cases, such as the Vanguard Group or the Templeton Funds, Y will hire outside investment advisory firms to manage a portion of the assets and scrutinize the outside advisers' performance.<sup>25</sup> As such, Vanguard and Templeton are, to a large degree, "managers of managers."<sup>26</sup> In other cases, such as Fidelity Investments, Y will hire its own securities analysts and traders to pick securities for Fund Y.

### *B. The Legal Restrictions on Personal Trading by Fund Managers*

The most distinctive feature of the regulation of fund managers and other "access persons"<sup>27</sup> is the narrow range of mandatory regulation combined

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23. ICA § 10(a), 15 U.S.C. § 80a-10(a). If an investment company has a regular broker or a principal underwriter on its board, a majority of the directors must be independent of the broker or underwriter. *Id.* In its recent study, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, the SEC's Division of Investment Management has proposed that the ICA be amended to require a majority of independent directors on all investment company boards and that independent director vacancies be filled by the remaining independent directors. DIVISION OF INV. MANAGEMENT, U.S. SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION xxix, 251-90 (1992) [hereinafter PROTECTING INVESTORS].

24. ICA § 15, 15 U.S.C. § 80a-15 (1994). The Division of Investment Management has proposed that the ICA be amended to give independent directors the authority to terminate advisory contracts. PROTECTING INVESTORS, *supra* note 23, at xxix, 268-69.

25. *Vanguard Group Shuffles Management of Funds in a Bid to Improve Returns*, WALL ST. J., Feb. 22, 1994, at B12 (noting the growing trend at Vanguard to contract out management of its funds to unaffiliated money managers which allows Vanguard to replace managers or management firms more easily) [hereinafter *Vanguard Shuffles Management*].

26. *Id.*

27. While the public controversy has focused on personal trading by "fund managers," the use of that term is somewhat inappropriate. The term "fund manager" is generally used to refer to the individual who has ultimate responsibility for selecting the securities for a given fund, e.g., John Kaweske.

The ICA and, more specifically, rule 17j-1 is directed to a larger group of "access persons." 17 C.F.R. § 270.17-1 (1995). "With respect to a registered investment company or an investment adviser," rule 17j-1(e)(1) defines "access persons" to include "any director, officer, general partner, or advisory person, as defined in this section, of such investment company or investment adviser." 17 C.F.R. § 270.17j-1(e)(1).

According to rule 17j-1(e)(2)(i), the term "advisory person of a registered investment company or an investment advisor thereof" refers, in pertinent part, to

[a]ny employee of such company or investment adviser (or of any company in a control relationship to such investment company or investment adviser) who, in connection with his regular functions or duties, makes, participates in, or obtains information, regarding the

with the requirement that fund managers' employers—the investment advisers—explicitly adopt and enforce a code of ethics. As I describe in this section, aside from securities regulations of general application, such as the general prohibition on insider trading under section 10(b) of the Securities Exchange Act of 1934<sup>28</sup> and rule 10b-5<sup>29</sup> promulgated thereunder, there are few mandatory restrictions on personal trading by fund managers.

### 1. General Regulations

Fund managers, like others, are subject to the prohibitions on insider trading that have developed under section 10(b) and rule 10b-5. Accordingly, a fund manager who trades on material nonpublic information from a corporate insider (i.e., a "tip") violates section 10(b) and rule 10b-5 if the insider breached his or her fiduciary duty to the issuer in disclosing the information and the fund manager knows or should know that there has been a breach.<sup>30</sup> Similarly, a fund manager who purchases shares for his or her own account shortly before recommending that security for long-term investment is liable under section 10(b) and rule 10b-5 if he or she then sells the personally-held shares at a profit during a rise in the market price following the recommendation.<sup>31</sup>

In addition, the SEC has consistently viewed "front running" as a trading abuse. The SEC defines front running as "trading a stock, option, or future while in possession of non-public information regarding an imminent block transaction that is likely to affect the price of the stock, option, or

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purchase or sale of a security by a registered investment company, or whose functions relate to the making of any recommendations with respect to such purchases or sales.

17 C.F.R. § 270.17j-1(e)(2)(i).

Rule 17j-1(c)(1) extends the filing requirements of 17j-1 to transactions involving any security in which the access person has "any direct or indirect beneficial ownership." 17 C.F.R. § 270.17j-1(c)(1). This language is broad enough to include accounts held by immediate family members. Consequently, many investment companies regard all employees and their immediate family members as access persons and require them to file quarterly reports under rule 17j-1. See ICI REPORT, *supra* note 16, at 11.

For the purpose of this article, I will use the terms *fund manager* and *access person* more or less interchangeably, except when a more precise usage is required.

28. Securities Exchange Act § 10(b), 15 U.S.C. § 78j (1994).

29. 17 C.F.R. § 240.10b-5 (1995).

30. *Dirks v. SEC*, 463 U.S. 646 (1983). This is commonly known as "tippee liability."

31. *SEC v. Blavin*, 557 F. Supp. 1304, 1310-13 (E.D. Mich. 1983), *aff'd*, 760 F.2d 706 (6th Cir. 1985). This practice is known as "scalping."

future.”<sup>32</sup> Although some front running could be viewed as a violation of section 10(b) or rule 10b-5, as discussed below, it could also constitute a violation of section 206 of the Investment Advisers Act.<sup>33</sup> However, front running has largely been handled through stock exchange rules<sup>34</sup> and investment adviser’s ethics codes rather than federal regulations.

## 2. *The Investment Company Act*

In addition to general regulations, personal trading by fund managers is regulated under section 17 of the Investment Company Act.<sup>35</sup> Section 17 regulates transactions by the fund,<sup>36</sup> and contains two provisions of direct relevance to personal trading. First, section 17(e) makes it unlawful for any fund manager, while acting as an agent for the fund, “to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company.”<sup>37</sup> In other words, section 17(e)(1) makes illegal the acceptance of any benefit—such as privileged access to an attractive investment opportunity or finder’s fees—in exchange for investing assets of the fund. Thus, a mutual fund manager who purchased for her own account valuable warrants made available by Drexel Burnham Lambert in exchange for purchasing junk bonds for her fund violated section 17(e).<sup>38</sup>

32. Memorandum from the Division of Market Regulation of the SEC Accompanying Letter from David S. Ruder, SEC chairman, to Congressmen John D. Dingell and Edward J. Markey, 11-12 (May 13, 1988) (citation omitted), *quoted in* Lewis D. Lowenfels & Alan R. Bromberg, *Securities Market Manipulations: An Examination and Analysis of Domination and Control, Frontrunning, and Parking*, 55 ALB. L. REV. 293 (1991).

33. *Id.* Although it has largely been assumed that front running violates § 10(b), rule 10b-5, and § 206 of the Investment Adviser’s Act, *see, e.g.*, ICI REPORT, *supra* note 16, at 6 n.16, there is little case authority on point. The SEC has been ambiguous on whether rule 10b-5 prohibits front running. *See generally*, Mahlon M. Frankhauser, *Intermarket Front Running: Background and Developments*, in BROKER DEALER INSTITUTE 1988, at 697 (PLI Corp. L. & Practice Course Handbook Series No. 621, 1988); Lowenfels & Bromberg, *supra* note 32, at 313-37.

34. The New York Stock Exchange and Chicago Board Option Exchange both promulgated rules against front running during the late 1980s. For a discussion of these interpretations, *see* Lowenfels & Bromberg, *supra* note 32, at 313-37. Fund managers fall within the ICA definition of “affiliated person” because they are employees of an investment adviser who, itself, is an affiliated person.

35. ICA § 2(a)(3), 15 U.S.C. § 80a-2(a)(3) (1994).

36. *See, e.g.*, ICA § 17(a)-(d) (mandating that fund securities be held by a custodian); (f) (requiring the bonding of officers and employees); (h)-(i) (prohibiting exculpatory provisions). 15 U.S.C. § 80a-17(a)-(d), (f), (h), (i) (1994).

37. ICA § 17(e), 15 U.S.C. § 80a-17(e).

38. *United States v. Ostrander*, 999 F.2d 27 (2d Cir. 1993). *See also* *Investors Research Corp. v. SEC*, 628 F.2d 168 (D.C. Cir. 1980); *United States v. Deutsch*, 451 F.2d 98 (2d Cir. 1971), *cert. denied*, 404 U.S. 1014 (1972); *United States v. Milken* 759 F. Supp. 109 (S.D.N.Y. 1990); *SEC v. Embry*, No.



Similarly, a mutual fund manager whose son received commissions from an issuer based on the fund's purchase of that issuer's securities would violate the Act as well.<sup>39</sup>

Second, section 17(j), adopted in 1970, provides a general grant of authority to the SEC to impose anti-fraud standards on fund managers.<sup>40</sup> This section evolved as "a response to the widely recognized need for the development of adequate restraint on the trading of investment company insiders in the companies' portfolio securities."<sup>41</sup> It permits the SEC to impose rules of restraint directly or to require investment companies and investment advisers to adopt codes of ethics which establish reasonable standards to prevent individual trading.<sup>42</sup>

In 1980, the SEC promulgated rule 17j-1, which does several things.<sup>43</sup> First, rule 17j-1(a) makes it unlawful for fund managers, among others, to engage in any fraudulent or deceptive practices against the investment company in connection with the purchase or sale of securities by or for the investment company.<sup>44</sup> Therefore, actions such as front running, accepting bribes and kickbacks, and scalping all violate rule 17j-1.

Over and above this general anti-fraud provision, rule 17j-1 also mandates that investment companies and investment advisers adopt a written code of ethics. Similar in scope to section 17(j), rule 17j-1 attempts to prevent any access person from engaging in any fraudulent or deceptive activity.<sup>45</sup> In addition, the investment company and its investment advisers

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13777, 1993 WL 342039 (S.D.N.Y. Sept. 9, 1993).

39. SEC v. Kaweske, No. 14399, 1995 SEC Lexis 330, at \*1 (D. Colo. Feb. 6, 1995).

40. ICA § 17(j) provides in relevant part:

It shall be unlawful for any affiliated person of . . . a registered investment company or any affiliated person of an investment adviser of . . . a registered investment company, to engage in any act, practice, or course of business in connection with the purchase or sale, directly or indirectly, by such person of any security held or to be acquired by such registered investment company in contravention of such rules and regulations as the Commission may adopt to define, and prescribe means reasonably necessary to prevent, such acts, practices, or courses of business as are fraudulent, deceptive or manipulative.

ICA § 17(j), 15 U.S.C. § 80a-17(j) (1994).

41. S. REP. NO. 184, 91st Cong., 1st Sess. 28 (1969). See also, H.R. REP. NO. 1382, 91st Cong., 2d Sess. 27 (1970).

42. ICA § 17(j), 15 U.S.C. § 80a-17(j) (1994).

43. 17 C.F.R. § 270.17j-1 (1995).

44. *Id.*

45. Rule 17j-1 provides that investment companies and, investment advisers, shall adopt a written code of ethics containing provisions reasonably necessary to prevent its access persons [including fund managers] from engaging in any act, practice, or course of business prohibited by paragraph (a) of this section and shall use reasonable diligence, and institute procedures reasonably necessary, to prevent violations of such code.

17 C.F.R. § 270.17j-1(b)(1).

must "use reasonable diligence, and institute procedures reasonably necessary, to prevent violations of [the ethical] code."<sup>46</sup> Finally, rule 17j-1(c) mandates that access persons report trades to their funds.<sup>47</sup>

In sum, aside from the general prohibition of the perpetration of fraud on investment companies, including a prohibition on bribes and kickbacks, rule 17j-1 mandates that investment advisers adopt and enforce explicit codes of ethics. The contents of those codes are left largely to the individual firms. This deference to the investment companies and investment advisers was hardly accidental. In the release accompanying rule 17j-1, the SEC explained:

[T]he variety of employment and institutional arrangements utilized by different investment companies renders impracticable a rule designed to cover all conceivable possibilities.<sup>48</sup>

This perceived impracticality led the SEC to adopt a policy which lets "individual entities take fully into account their own unique circumstances in designing their codes of ethics prescribing standards of conduct which effectuate the purposes of the Rule."<sup>49</sup> The Commission felt the introduction and tailoring of these ethical restraints should be left with the directors of the investment company because they can best assess what is needed.<sup>50</sup>

While leaving the contents of the codes to the individual firms, the SEC indicated that it expected firms to address certain potentially abusive activities in their codes.<sup>51</sup> The SEC identified a number of situations as raising particular concerns. Specifically, it included the conflicts of interest that arise when access persons engage in personal transactions involving securities that the investment company has acquired, will acquire or is considering acquiring.<sup>52</sup>

### 3. *The Investment Advisers Act*

The Investment Advisers Act<sup>53</sup> likewise applies to personal trading by

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46. *Id.*

47. 17 C.F.R. § 270.17j-1(c).

48. Prevention of Certain Unlawful Activities with Respect to Registered Investment Companies, Exchange Act Release No. 11,421, 1980 WL 25707, at \*2 (October 31, 1980).

49. *Id.* at \*4.

50. *Id.* at \*2.

51. *Id.*

52. *Id.*

53. Investment Advisers Act of 1940, Pub. L. No. 103-317 (codified as amended at 15 U.S.C. § 80b-1 to 80b-21 (1994)) [hereinafter IAA].

fund managers. Section 204A, added in the Insider Trading and Securities Fraud Act of 1988,<sup>54</sup> requires each investment adviser to "establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser."<sup>55</sup> As a complement to section 204A, Congress added section 21A to the Securities Exchange Act of 1934 at the same time.<sup>56</sup> Section 21A provides a clearer standard making an investment adviser liable for knowingly or recklessly failing to prevent trading on material nonpublic information by one of its fund managers.<sup>57</sup>

Section 206 of the Investment Advisers Act adds additional restraints prohibiting fraudulent or manipulative transactions by investment advisers.<sup>58</sup> Thus, a fund manager who purchases shares for his or her own account shortly before recommending that security for long term investment, and sells the shares at a profit upon the rise in the market price following the recommendation (i.e., scalping), violates section 206, in addition to rule 17j-1, section 10(b) and rule 10b-5.<sup>59</sup> Front running also falls within the prohibitions of section 206.<sup>60</sup> Similarly, a fund manager who directly or indirectly receives secret commissions from an issuer for purchasing securities on behalf of the fund is in violation.<sup>61</sup>

In combination, the various regulations result in the mandatory prohibition of trading on material nonpublic information, bribes and kickbacks, and trading in advance of the fund (i.e., front running and scalping). Beyond these core offenses, however, the effect of ICA section 17(j) and rule 17j-1 is to require what is, in essence, private ordering by explicit contractual terms controlling the conflicts of interest inherent in

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54. Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended in scattered sections of 15 U.S.C.).

55. IAA § 204A, 15 U.S.C. § 80b-4a (1994).

56. 15 U.S.C. § 78u-1.

57. *Id.*

58. IAA § 206 provides in relevant part:

It shall be unlawful for any investment adviser . . . (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

IAA § 206(4), 15 U.S.C. § 80b-6(4) (1994).

59. SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963).

60. See, ICI REPORT, *supra* note 16, at 6 n.6.

61. SEC v. Kaweske, No. 14399, 1995 SEC LEXIS 330, at \*1 (D. Colo. Feb. 6, 1995).

personal trading by fund managers. In contrast to insider trading regulations, where the same rules apply across the board, the statutory scheme governing personal trading by fund managers anticipates and indeed encourages different approaches by different firms, depending on their individual needs. Although explicitly acknowledging the conflicts of interest posed by personal trading by fund managers, the SEC, in 1980, did not ban such trading outright. It is to these codes that I now turn.

## II. THE ETHICS CODES: AN OVERVIEW

In response to the controversy over personal trading by fund managers, the ICI surveyed current ethics codes of its members. Ninety-six investment company complexes, associated with over 2,150 mutual funds, and representing nearly ninety percent of mutual fund assets, responded.<sup>62</sup> The survey indicated both commonality and diversity, with greater uniformity in enforcement procedures than in substantive content.<sup>63</sup>

Funds have largely adopted the same enforcement technology. All ninety-six fund complexes mandate some type of preclearance, i.e. notification and approval before trading, for personal securities transactions.<sup>64</sup> Of the ninety-six funds, sixty-two mandated preclearance for all personal securities transactions, with defined exceptions, while thirty-four mandated preclearance for certain defined transactions.<sup>65</sup> This uniformity is striking insofar as preclearance is not required under rule 17j-1. While not required, preclearance is nevertheless critical to detecting, preventing and discouraging front running and scalping.

Similarly, all ninety-six funds imposed reporting requirements on access persons (as required under rule 17j-1), but varied somewhat on the form and frequency of reporting.<sup>66</sup> As an additional check on personal trading activity, twenty-seven fund complexes require the submission of monthly brokerage statements; twenty-two require brokerage confirmations; and ten go so far as to require employees to trade through the firm.<sup>67</sup>

There was substantially greater diversity on the substantive provisions of the codes. Of the ninety-six complexes surveyed, only twenty-five explicitly

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62. See ICI REPORT, *supra* note 16, app. II, at 3.

63. *Id.*

64. *Id.*

65. *Id.*

66. Seventy-eight require reporting on a quarterly basis, thirteen monthly, and five on a transactional basis. *Id.*

67. *Id.* app. II, at 5.

restricted initial public offering ("IPO") purchases and only seven funds explicitly restricted private placement purchases.<sup>68</sup> Additionally, sixty-three of the ninety-six funds restricted trading by specified personnel concurrent with the trading of their funds, imposing a range of time restrictions upon their personal activity before and after any trade by the fund.<sup>69</sup> Fifteen of ninety-six funds expressly discouraged or prohibited short term trading, with two complexes requiring securities to be held for thirty days, one for sixty days and one for ninety-one days.<sup>70</sup> Thirty-seven complexes had restrictions on the receipt of gifts, with eighteen prohibiting the receipt of gifts, eight permitting gifts of less than fifty dollars annually, and seven of less than \$100 annually.<sup>71</sup> Ten complexes explicitly restricted service as a director or trustee on the board of another company.<sup>72</sup>

The SEC's survey of thirty investment companies found similar patterns.<sup>73</sup> Twenty-one prohibited access personnel from purchasing or selling any security that he or she knows is being considered for purchase or sale, or are being purchased or sold, by the fund.<sup>74</sup> Sixteen fund groups imposed a black out period ranging from one to thirty days.<sup>75</sup> Five fund groups were found to prohibit or restrict purchases of IPOs; nine other groups prohibited or restricted purchases of "hot issue" IPOs.<sup>76</sup> Five groups restricted purchases of private placements and four fund groups banned short term trading.<sup>77</sup>

Regarding enforcement methodology, nineteen fund groups required pre-clearance of all personal trades, while four fund groups had more limited preclearance requirements.<sup>78</sup> Eighteen fund groups required employees to report securities transactions contemporaneously, a more stringent requirement than the quarterly reporting required under rule 17j-1.<sup>79</sup> Only one fund group required new employees to disclose securities holdings upon beginning employment.<sup>80</sup>

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68. *Id.*

69. ICI REPORT, *supra* note 16, app. II, at 5.

70. *Id.*

71. *Id.*

72. *Id.*

73. See SEC REPORT, *supra* note 17, exhibit B.

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*



Beyond these aggregate patterns, it is difficult to determine the details of specific firms' ethics codes. By and large, firms refuse to provide copies of their ethics codes, presumably for two reasons. First, they may not want to be cross-examined about them or required to explain the inevitable violations by personnel. Second, and more speculatively, to the extent that controlling conflicts of interest is a management problem, they may not want to share their solutions with their competitors.

Published reports provide some details of firms' ethical codes. At one extreme is Berger Associates, a \$2 billion fund complex, which prohibits personal trading entirely.<sup>81</sup> By contrast, Fidelity Investments, the largest fund complex, permits personal trading, but only under circumscribed conditions.<sup>82</sup> According to descriptions of Fidelity's procedures, the rules include the following:

- \* Portfolio managers must clear all equity investments in personal accounts through Fidelity's head of trading prior to making a transaction. In determining whether to approve the trade, the head of trading looks at all activity of Fidelity funds with a view to a conflict of interest.<sup>83</sup>
- \* Portfolio managers aren't allowed to buy a security for their own accounts for five days before or after they bought or sold it for their fund. Managers' green light to buy a stock lasts only one day.<sup>84</sup>
- \* All personal investments are reported monthly and reviewed by the compliance staff. They also are reviewed by independent auditors semiannually.<sup>85</sup>
- \* Fidelity's compliance staff of sixty conducts ongoing training and education courses for Fidelity's 300 investment professionals. Each year, portfolio managers must sign a revised version of the company's code of ethics.<sup>86</sup>
- \* If a fund manager has an investable idea, he or she must inform all the other managers before buying any shares for his or her personal account, and must then wait a week before buying the stock.<sup>87</sup>
- \* Trading restrictions apply to any stock with a market capitalization, or total

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81. *Id.* at 26 n.77. See also, B.J. Phillips, *Mutual Funds, Mutual Conflicts*, PHILA. INQUIRER, Mar. 9, 1994, at C1.

82. Doug Rogers, *Some Managers Forswear Personal Trading: Berger's Linafelter Says Fund Must Be Adviser's Only Priority*, INVESTOR'S BUS. DAILY, Mar. 8, 1994, at 29.

83. Doug Rogers, *Funds Keep Tight Rein On Managers' Trading*, INVESTOR'S BUS. DAILY, Mar. 4, 1994, at 5.

84. *Id.*

85. *Id.*

86. *Id.*

87. Fromson, *supra* note 13, at A1.

market value, above forty million dollars.<sup>88</sup>

- \* Fidelity analysts, who provide research to fund managers, must wait at least five days after issuing a recommendation before trading the stock.<sup>89</sup>
- \* A prohibition against portfolio managers calling companies to get information unless they include the Fidelity research analyst who covers the company, or tell the analyst the substance of the conversation, so that the analyst can alert other managers who might want to buy the stock for their funds.<sup>90</sup>

T. Rowe Price, another large fund group, follows a similar approach. Portfolio managers are required to report personal transactions within ten days.<sup>91</sup> In addition, whenever a new stock enters a T. Rowe fund, the firm looks back to see if any T. Rowe manager bought it in the past twelve months.<sup>92</sup>

### III. PERSONAL TRADING BY FUND MANAGERS: CONFLICTS OF INTEREST AND MANDATORY RULES

What, then, are the conflicts of interests between the funds and the fund managers with respect to personal trading, and why should the law worry about these conflicts? In this section, I will consider the incentives facing fund managers, the incentives facing their employers, the investment advisers, and the interests of the fund investors.

#### *A. Fund Managers' Incentives*

Consider, first, the conflicting incentives facing fund managers. Fund managers are agents, typically of the fund's investment adviser, and present a classic agency problem. The core conflict of interest is that fund managers receive 100% of the net profits made on personal trading but only indirect benefits from profits on trades by the fund they advise. Benefits may come in a variety of forms. First, whether or not fund managers keep their jobs or get better jobs depends, in large measure, on their performance. Second, fund managers' compensation may be tied to their performance. Third, fund managers may have their own money invested in their funds.

The opportunities for abuse also arise in a number of ways. First, fund

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88. Rogers, *supra* note 83, at 5.

89. *Id.*

90. Fromson, *supra* note 13, at A1.

91. Rogers, *supra* note 83, at 5.

92. *Id.*

managers have a financial incentive to front run. For example, a manager who buys or sells stock in advance of a purchase or sale by the fund that the manager believes will move the stock price. Variants of this practice are possible. Thus, a fund manager might purchase or sell a security in advance of the purchase or sale of the security by a different fund in the same fund complex. Similarly, a fund manager might purchase a security and then casually recommend the security to managers of other funds in the same complex, hoping that they will purchase it for their funds and move the price.

A second type of conflict involves the diversion of fund investment opportunities and conversion of fund property. Specifically, a fund manager who, in the course of working for the fund, comes across a particularly attractive stock will have an incentive to purchase that stock for a personal account. However, to avoid front running, the fund manager may refuse to purchase it for the fund, or instead purchase it substantially later, after the blackout period ends.<sup>93</sup> Similarly, a fund manager who executes trades without listing the fund for which it was being made, and then later allocates the profitable trades to an account benefiting employees while allocating unprofitable trades to the funds, diverts investment opportunities.<sup>94</sup>

A third type of conflict of interest arises when personal trading leads a fund manager to shirk, to work less on picking stocks for the fund he or she manages. As John Neff, long time head of Vanguard's Windsor Fund, put it, "You are spending an awful lot of your waking hours managing your own portfolio when you should be looking after the fund. The fund must come first. You should not be managing your own money actively while you are managing other people's money actively."<sup>95</sup> Andrew Cox, a trustee of the Montgomery Funds, argues that personal trading by fund managers means: "They're spending time analyzing stocks that aren't

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93. The blackout period is the period of time during which the SEC scrutinizes any trades made by an insider.

94. See, e.g., Order Instituting Proceedings Pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings and Imposing Remedial Sanctions, No. 3-8712, 1995 SEC LEXIS 1312, at \*1 (June 6, 1995) (imposing remedial sanctions on a former portfolio manager who delayed reporting accounts to gain a more favorable price); Order Instituting Proceedings Pursuant to Sections 203(e)(5) and 203(k) of the Investment Advisers Act of 1940, and Findings and Order Imposing Remedial Sanctions, No. 3-8207, 1993 SEC LEXIS 3426, at \*1 (Oct. 20, 1993) (holding liable an investment company for failing to stop a portfolio manager from delaying designating accounts).

95. Fromson, *supra* note 13, at A1.

benefiting the fund. They can all say, 'I do it at home after my kids are in bed,' but, well, give me a break."<sup>96</sup> This potential for shirking is, of course, a generic problem, applying equally to personal trading by corporate managers and academics.

### *B. The Benefits of Personal Trading*

Given these risks, why might rational fund advisers seek to regulate personal trading rather than banning it outright? From the fund adviser's perspective, several answers are given. First, fund advisers argue that permitting personal trading, with limitations, is necessary to attract and retain the right sort of fund manager. Top managers often like to trade for their personal accounts. William Hayes, managing director and head of the equities group at Fidelity explained: "[W]e're looking for market animals, people who are players. We look for money makers, people who know what the game is all about."<sup>97</sup> Roy Adams, a mutual fund lawyer, added: "I think it's necessary to think about what the fund manager is. By and large, these are people who live, breathe and die the stock market. This is their passion. Many of them started trading stocks at 12."<sup>98</sup>

Had Fidelity told Peter Lynch, the fund manager credited with the extraordinary success of Fidelity's Magellan fund, that he could not do any personal trading, he might well have gone to work elsewhere.<sup>99</sup> In contrast, hedge funds, bank common trust and investment funds, and insurance companies are already less strictly regulated.<sup>100</sup> A Peter Lynch could work for one of them and continue to manage money while trading.

A second explanation is that personal trading sharpens fund managers' skills.<sup>101</sup> A former Fidelity manager said: "They want people to realize this is not a game—it really matters. And when you lose your own money,

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96. Susan Antilla, *Wall Street; Fund Managers Testing the Rules*, N.Y. TIMES, Jan. 23, 1994, § 3, at 15.

97. Bailey & Zinter, *supra* note 19, at A1.

98. CNN, *Inside Business* (CNN television broadcast Jan. 30, 1994).

99. Fromson, *supra* note 13, at A1.

100. For example, hedge funds (collective investment funds with fewer than 100 investors who, as a result, fall outside the definition of "investment company" in 15 U.S.C. § 80a-3(c)(1) (1944)), bank common trust and collective investment funds, commodity pools, and insurance companies are all subject to substantially less stringent regulation. For an overview of the different (and more lax) regulations, see *Summary of Standards Applicable to Other Managers of Pooled Investment Vehicles*, ICI REPORT, *supra* note 16, app. VI (prepared by Fried, Frank, Harris, Shriver & Jacobsen).

101. Fromson, *supra* note 13, at A1 (quoting Robert Pozen, general counsel at Fidelity, as saying: "We know that Peter Lynch did some personal trading and felt it sharpened his skills").

it has an impact on you.”<sup>102</sup>

Third, firms can learn a lot about the behavior, taste and integrity of their access personnel from their personal trading. How employees behave with their own money may tell the firm a great deal about how they will behave with other people's money.<sup>103</sup>

Finally, because fund managers can make significant amounts from personal trading, it could be costly for a firm to ban it. The firm would have to cover at least a portion of the lost income or risk losing the best managers.

In light of these potential benefits, many investment advisers have chosen to control or limit personal trading rather than banning it.<sup>104</sup>

### C. *Mutual Fund Investors*

What, aside from jealousy, should trouble mutual fund investors about the possibilities for abuse? The harm to investors can be divided into three categories. First, to the extent that fund managers divert trading opportunities to their personal portfolios, shirk, cause the fund to pay higher prices for a security, or cause the fund to purchase a security it would not otherwise buy in order to front run, the fund's returns will be compromised, directly harming investors.

Second, and independent of the effect on returns, personal trading abuses may lead an investor to lose confidence in a particular fund. This forces the investor to bear the costs of identifying a new fund, and then shifting his or her investments. The transaction costs associated with shifting the investment will vary depending on whether the fund is an open or closed-end fund, and whether it is a load or no-load fund.

Third, trading abuses, as well as other ethical lapses by fund managers, may lead investors to lose confidence in the integrity of the mutual fund sector as a whole, leading them to shift their assets elsewhere. If this were to occur, it would impose costs both on investors, who would have to find another investment opportunity, as well as on society, to the extent that mutual funds are an important and low cost source of investment capital.

It is this last concern that seems to lie behind much of the condemnation of personal trading. J. Carter Beese, Jr., an SEC commissioner, articulated this concern: “The issues go beyond whether a violation may have

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102. Bailey & Zitner, *supra* note 19, at A1.

103. I owe this point to Amir Ziv, Columbia Business School.

104. See *supra* notes 62-90 and accompanying text.



occurred. The mutual fund industry has been built on trust. The public must have confidence in those investing their money, or they might lose confidence in the industry as a whole."<sup>105</sup>

But the importance of public confidence does not, by itself, justify regulatory intervention. One must first examine the incentives that the fund managers' employers, the investment advisers, have to control it.

#### *D. Fund Advisers' Incentives and the Need for Regulatory Intervention*

Personal trading by fund managers is an activity that imposes costs but may also create benefits. Before turning to the question of the appropriate role for the SEC in regulating personal trading, the fund advisers' private incentives must first be analyzed.

Consider the first type of harm posed by personal trading: impaired investment performance. The fund manager's employer—the fund's investment adviser or a subcontracting investment adviser—has substantial incentives to maximize performance, and therefore a strong incentive to control abusive behavior by the fund manager. Studies of mutual funds consistently indicate a complex relationship between investment performance and asset flows.<sup>106</sup> Strong evidence indicates that investors direct funds in response to new information about performance. Ippolito, for example, finds "a clear underlying movement of investment monies in the mutual fund industry toward recent good performers and away from recent poor performers over the period 1965-84."<sup>107</sup> Ippolito also found evidence that recent performers continue to perform well, providing a rationale for investment algorithms that favor recent performers.<sup>108</sup>

While early studies suggested a linear relationship between performance and asset flows,<sup>109</sup> more recent work indicates that the relationship is

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105. Bailey & Zitner, *supra* note 19, at A1. See also Hinden, *supra* note 19; Petruno, *supra* note 19.

106. JUDITH CHEVALIER ET AL., RISK TAKING BY MUTUAL FUNDS AS A RESPONSE TO INCENTIVES (National Bureau of Economic Research Working Paper No. 5234, 1995); Richard A. Ippolito, *Consumer Reaction to Measures of Poor Quality: A Study of Mutual Fund Performance 1965-84*, 35 J.L. & ECON. 45 (1992); A. Edward Spitz, *Mutual Fund Performance and Cash Inflow*, 2 APPLIED ECON. 141 (1970); Kevin V. Smith, *Is Fund Growth Related to Fund Performance?*, J. PORTFOLIO MGMT. Spring 1978, at 49; J. Patel et al., *Investment Flows and Performance: Evidence from Mutual Funds, Cross-Border Investments, and New Issues*, (Harvard Univ. Working Paper 1990); Erik R. Sirri & Peter Tufano, *Buying and Selling Mutual Funds: Flows, Performance, Fees, and Services* (1993) (Harvard Bus. Sch. Working Paper, on file with author).

107. Ippolito, *supra* note 106, at 67.

108. *Id.* at 60-69.

109. Patel et al., *supra* note 106; Smith, *supra* note 106; Spitz, *supra* note 106.

uneven and asymmetrical: More assets flow to superior performing funds than flow away from poor performers.<sup>110</sup> Moreover, most of the asymmetry is driven by very large inflows of investment capital to the highest ranked firms.<sup>111</sup> Outside of the top quintile, performance and asset flows are weakly related.<sup>112</sup> Indeed, according to Sirri and Tufano, there is surprisingly little evidence of money flowing out of the poorest performers.<sup>113</sup>

This strong asymmetry suggests that funds have an incentive to take on excessive risk in order to become "stars." If the risk pays off and a firm places in the top quintile, it will see large asset growth; however, if the risk does not pay off and returns suffer, firms will face much smaller asset outflows.<sup>114</sup> This effect may be particularly pronounced in fund complexes, where having a "star" fund may redound to the benefit of the complex as a whole.

While the weakness and asymmetries in the relationship between performance and asset flows create a potential for agency costs in the mutual fund context, they do not undermine significantly the assumption that funds will care about actions by access personnel that impair performance. Indeed, a fund's desire to place in the top quintile should make it *especially* vigilant in preventing trading by access persons which diverts favorable investment opportunities.

In light of these correlations between investment performance and asset flows (and the associated fees), funds, whether they manage money in-house or contract it out, have strong incentives to control abusive behavior. Consider, first, the Vanguard and Templeton approaches, in which the fund adviser contracts out active equity management.<sup>115</sup> The supervising fund adviser has access to the full range of highly sophisticated measurement instruments to direct money to outside firms which perform well, and away from funds that perform badly.<sup>116</sup> Indeed, one advantage of using outside money managers, claims Vanguard, is that it is easier to change managers

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110. Ippolito, *supra* note 106, at 61-64; Sirri & Tufano, *supra* note 106, at 13-24.

111. Sirri & Tufano, *supra* note 106, at 3.

112. *Id.* at 14-15.

113. *Id.*

114. *Id.* at 35.

115. See *Vanguard Shuffles Management*, *supra* note 25, at B12.

116. While Vanguard's CEO, John Bogle, may express his view that personal trading by fund managers should be prohibited, what Vanguard cares about is the investment performance of the money management firms it retains. Anise C. Wallace, *Closed-End Fund Facing Challenge*, N.Y. TIMES, Dec. 15, 1987, at D12.

if performance lags.<sup>117</sup> Competition among money management firms to attract capital will thus impose pressure on the firms to adopt whatever approach to managing its employees' conflicts of interest is best for its style of investing and for the kind of employees it attracts.

In this context, what is important is that there is no particular reason to believe that the same approach to managing potential conflicts of interests will be optimal for all firms. For example, one investment adviser may take the view that hiring managers who live and breathe stocks, who want to trade all the time and who cannot conceive of not trading for their own accounts, will maximize returns. Another firm might take the view that personal trading leads employees to shirk on firm work and that a ban on personal trading will maximize returns by directing all energies into firm business. If the first firm is right, Vanguard and others will send it more money and it will receive higher management fees and prosper. If the second firm is right, it will thrive for the same reasons. Indeed, both firms may be right, each adopting an approach that suits its strategy and employees.

This same set of incentives exists even when fund managers work directly for the fund adviser. The only difference is that all functions now take place within a single firm. Thus, Fidelity, unlike Vanguard, largely manages its money in-house.<sup>118</sup> But, like Vanguard, Fidelity is driven to maximize performance, and has incentives to adopt a policy on personal trading that will do so. As before, there is no reason to believe that the same policy will be optimal for all of its funds. One might, for example, impose no limitations on personal trading by employees who manage an S & P 500 index fund, while imposing significant limitations on managers who manage a small capitalization growth fund. Or the complex might worry that the S & P 500 index manager will pick up information over lunch with the small cap growth fund manager and impose identical limitations on both funds. Along the same lines, a small fund complex like Berger Associates may have adopted its ban on personal trading as a mechanism for self selection. Forcing managers to invest in the fund may allow Berger to screen out managers with an insufficient appetite or tolerance for risk. In each of these cases, the choice of what sort of policy on personal trading is likely to maximize returns is quintessentially a management decision. Therefore Fidelity, Vanguard, or Berger, will reap

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117. See *Vanguard Shuffles Management*, *supra* note 25, at B12.

118. See, e.g., Jerry Ackerman, *Henning to Run Fidelity Fixed Income Group*, BOSTON GLOBE, May 4, 1995, at 83.

the benefits of a good solution and bear the cost of a bad solution, as money flows in or out based on investment returns. By trying to maximize funds under management, the fund adviser is well positioned to protect investors from harm to performance caused by personal trading.

The pressure on fund advisors to maximize returns, then, provides investors with substantial protection against trading practices that impair performance. In this connection, the SEC has an important role to play in ensuring that timely, accurate and comparable information on performance is provided to the market.<sup>119</sup> As with other consumer products, "consumer vigilance is more efficacious if the market has access to systematic and comparable information across brands."<sup>120</sup> But, to the extent that the personal trading controversy is about investment performance, the market's responsiveness to mutual fund performance makes unnecessary broader SEC involvement.

As discussed above, however, the controversy over personal trading is not, solely or perhaps even centrally, a controversy over whether personal trading interferes with maximizing investment performance. Rather, a core concern seems to be that personal trading will lead investors to lose confidence in mutual funds and consequently stop investing.

To the extent that investors care about characteristics of particular funds other than risk and return—and therefore might incur the costs of switching to a more ethical fund—fund advisers have incentives to respond. Thus, to the extent that investors care about "social responsibility," fund advisers have an incentive to establish and advertise funds that respond to these concerns, such as the Calvert Social Investment Funds.<sup>121</sup> Alternatively, if investors care about the potential ethical impropriety of personal trading, funds likewise have an incentive to market themselves as funds that ban personal trading. Whether such funds would attract investment would be a direct test of investors' concern with personal trading.

#### *E. The Core Market Integrity Argument*

The previous incentive responses, however, fail to appreciate fully the concern with "market integrity." Investors worry about "integrity," even if they have full information about past performance, because the controls on

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119. See Alan Boyd, *Thai Regulators Target Small Investors with Mutual Fund Reforms*, BUS. TIMES, July 20, 1993, at 10; Bill Rumbler, *Fidelity's 'Slopiness' Stirs Call for Change*, CHI. SUN-TIMES, June 24, 1994, at 45.

120. Ippolito, *supra* note 106, at 67.

121. William Smart, *The Greening of America, Part II*, WASH. POST, July 5, 1984, at B5.



stealing are necessarily imperfect. Despite the existence of laws against embezzlement and no matter how good the past performance, a rational investor would not invest with a thief, because past performance will, in such cases, be an insufficient guide to future performance.

To the extent that investors care about the trading policies of specific funds as a proxy for managerial honesty, the funds have an incentive to respond, and can respond adequately. But the core concern of those worried about personal trading is at the systemic level, potentially beyond the reach of individual fund action. The concern is that unsophisticated investors will consider themselves unable to distinguish between honest and dishonest funds, i.e., funds with credible ethical codes and those without. Thus, distrusting the industry as a whole, the investor will move their money to alternate forms of investments.

On this construction, the market integrity worry is a problem of asymmetrical information and costly signaling.<sup>122</sup> Specifically, the market integrity argument is a claim that asymmetric information regarding the personal trading policies and practices of fund advisors, and the fund advisors inability to distinguish themselves, threaten to drive investors from the industry.

Whether there is, in fact, a threat that consumers will lose confidence in the integrity of the mutual fund market is, of course, an empirical claim. Like many empirical assumptions underlying policy making, there is precious little evidence on whether or not it is correct. What evidence exists is mixed and utterly inconclusive. The American Association of Individual Investors said shortly after the Kaweske scandal broke that it had not been receiving comments regarding the ethics of the fund managers, but had

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122. For a comprehensive treatment of the economics of imperfect information, see Joseph E. Stiglitz, *Imperfect Information in the Product Market*, in HANDBOOK OF INDUSTRIAL ORGANIZATION 769 (Richard Schmalensee & Robert D. Willig eds., 1989).

The market integrity worry is thus similar to but different from the famous "lemons" market. In Akerlof's classic analysis of the used car market, George Akerlof, *The Market for Lemons: Qualitative Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970), the inability of consumers to distinguish between good and bad used cars leads consumers to offer no more for good used cars than for bad. Such an outcome is inefficient as consumers would be willing to pay more for a good used car, and sellers of good used cars would very much like to receive more for their cars. *Id.* at 489. This will not occur without a credible mechanism for distinguishing the good cars from the lemons. *Id.* at 499. As Ippolito explains, the mutual fund market differs critically from a "lemons" market because there is public information on past performance, and past performance is correlated to some extent with future performance, precisely what is missing in the used car market. Ippolito, *supra* note 106, at 56-66.



heard complaints from Invesco investors furious that Kaweske was fired.<sup>123</sup> Jack Bowers, editor of *Fidelity Monitor*, a newsletter that tracks Fidelity funds, received 100 calls in three days from investors worried about the impact of the drop in the Hong Kong stock market but only one call on the trading issue.<sup>124</sup> At the same time, there were numerous newspaper articles and editorials condemning personal trading. The *Washington Post* printed several prominent articles which could be expected to have a disproportionate impact "inside the beltway."<sup>125</sup> Moreover, the fact that there was no present indication of a problem does not mean that confidence was not being eroded and, similarly, by the time there is evidence of erosion, it may be too late to do anything about it. I will therefore assume that there is substantial reason to worry that the controversy over personal trading poses a threat to the mutual fund industry.

What, then, are the appropriate regulatory responses? Markets routinely respond to potential problems arising from consumers' inability to observe product quality directly and before purchase in markets with imperfect information. Common mechanisms include the seller's interest in preserving its reputation, and other types of "bonds," disclosures, certifications by third party information specialists, and guarantees.<sup>126</sup> Before considering whether the SEC has a role to play, one needs first to focus on the likely market responses to actual or threatened erosion of investor confidence in the mutual fund industry.

A firm's desire to preserve its reputation as a trustworthy custodian of investor funds is likely to provide a strong incentive for the firm to adopt standards of behavior for fund managers that both protect investors and are perceived to protect investors. One method a firm might adopt would be to disclose its policies on personal trading. Disclosure, alone, is generally not sufficient to solve an asymmetrical information problem because both good and bad firms would have an incentive to pretend to be good firms. Rather, the disclosures must be credible. Under the general disclosure rules of the

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123. James M. Pethokoukis, *Controversy Has Yet To Sully Funds' Image*, INVESTOR'S BUS. DAILY, Mar. 4, 1994, at 1.

124. Bailey & Zitner, *supra* note 19, at A1.

125. See, e.g., Fromson, *supra* note 13; Stan Hinden, *Avoiding Conflicts—Real and Perceived; Mutual Fund Managers Shouldn't Make Trades, If Only Because It Looks Bad*, WASH. POST, May 22, 1994, at H3.

126. Stiglitz, *supra* note 122. For a preliminary discussion of bonding by funds, see Ippolito, *supra* note 106, at 66-67.

securities laws<sup>127</sup> a fund adviser who has a bad ethics code but falsely claims to have a good code in order to induce investors to purchase shares of the fund violates section 10(b) and rule 10b-5, as well as section 17 of the ICA and section 206 of the IAA. Because of the prohibitions against and potential liability for misleading disclosures, securities disclosures have greater inherent credibility than other sorts.

But suppose consumers were too unsophisticated to read and understand the differences between different trading policies? An alternative approach would be for funds to adhere to (and to announce their adherence to) a "Code of Best Practices." One saw this sort of response by publicly traded firms in response to criticism over investment policies in South Africa when firms announced their adherence to the "Sullivan Principles."<sup>128</sup> The analogue for the mutual fund industry might be a "Code of Best Practices" prepared by the ICI. But note the importance of adopting a code that really does represent the "best practices": Once a code becomes widespread, firms may feel an obligation to adopt it, whether or not it is optimal or even useful.<sup>129</sup> Moreover, when a trade group adopts a code of best practices under pressure from regulators (and in order to preempt regulation), its voluntary nature is further eroded.

Another approach that typically emerges when imperfect information is a problem is the independent information specialist. With respect to consumer goods, *Consumer Reports* plays this role. With respect to publicly held companies, audits provide a similar assurance. To the extent that personal trading undermines the industry, one would expect the emergence of a similar sort of certification in the securities markets.

But waiting for a market response to the personal trading controversy might be viewed as inadequate, either because of the possibility that the market may react too slowly, with insufficient seriousness, or because of political pressure to act. If regulators feel compelled to act, either directly or through putting pressure on funds to adopt ICI recommendations, in what direction should they focus their energies?

To the extent that the market integrity argument is a claim about asymmetric information and costly signalling—my best reconstruction of

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127. 15 U.S.C. §§ 77a-77aa, 78a-78ll (1994).

128. Peter Behr, *Can U.S. Firms Do Well Abroad and Do Good? Clinton Teams Seek Ethical Business Codes*, WASH. POST, July 8, 1994, at F1.

129. In this regard, ethics codes may exhibit both positive and negative network externalities. See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

the argument—a narrowly tailored regulatory response would seek to ameliorate these inadequacies. Thus, one strategy for preventing or overcoming an asymmetric information problem would be to focus on improving the quality, quantity, and comparability of the information available to the market. In particular, the SEC might require funds to return to the prior requirement (apparently eliminated in a paperwork reduction move) that fund advisors file their ethics codes as an attachment to their annual disclosure forms, or require a summary of personal trading policies, either in the prospectus itself or in their Statements of Additional Information.<sup>130</sup> This would be a direct response to the problem of asymmetric information that lies behind the (assumed) market integrity worry.

But, some might argue, this still misunderstands the nature of the problem: Even with full disclosure, investors in the mutual fund industry are unsophisticated and will be unable to understand and distinguish between honest and dishonest funds. This argument is problematic. First, it ignores the extent to which the mutual fund market behaves as if consumers were vigilant with respect to the quality of investment performance.<sup>131</sup> A second and related point is that the argument ignores the extent to which shoppers (sophisticated investors) protect non-shoppers (unsophisticated investors).<sup>132</sup> In markets without price discrimination, such as securities markets, competition for even a relatively small number of marginal buyers (shoppers) will protect non-shoppers. Even if the ordinary investor does not read the disclosure material, so long as informed and active traders incorporate the information, such investors will be protected.

But suppose that one concluded that the nature of the mutual fund industry is sufficiently distinct from other product markets<sup>133</sup> that normal market responses to information asymmetry combined with credible

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130. ICI REPORT, *supra* note 16, at 49 (recommendation 5); SEC REPORT, *supra* note 17, at 33 (recommendation 1).

131. See Ippolito, *supra* note 106.

132. Alan Schwartz & Louis Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983) [hereinafter *Imperfect Information*] (arguing that competition for shoppers protects non-shoppers of warranty and security interests due to the absence of an ability to price discriminate); Alan Schwartz & Louis Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 638 (1979) [hereinafter *Intervening in Markets*] (arguing that competition among firms for shoppers may protect non-shoppers, at least in the absence of an ability to price discriminate).

133. This distinction may arise because of particularly unsophisticated consumers or because the product is but a collection of abstract legal rights, depriving consumers of a tire to kick.

mandatory disclosure are inadequate? Here we reach the critical weakness in regulatory strategy: Any additional regulatory intervention will necessarily be *ad hoc*, seeking to reassure investors through alternative strategies. The underlying asymmetrical information problem does not provide a theory of regulation beyond that designed to remedy the underlying asymmetry of information or costliness of signalling. The dangers of wider regulatory intervention increase because steps taken in the expectation of reassuring investors (whose nervousness is largely conjectural) may in fact hurt investors by limiting the ability of funds to adopt optimal approaches. As the discussion of the recommendations of the ICI Advisory Committee and the SEC's Division of Investment Management will show, the ICI and SEC have taken each of these approaches.

#### IV. THE ICI RECOMMENDATIONS

In response to the personal trading controversy, and the resulting pressure for action by the SEC and Congress, the Investment Company Institute formed an advisory committee to survey current personal trading practices and to formulate recommendations.<sup>134</sup> Relying on the preceding analysis, I now turn to these recommendations.

The Advisory Committee's recommendations can be divided into four categories. First, it recommended that every investment company include in its code of ethics a statement of "general fiduciary principles that govern personal trading," including: a "duty to place the interests of investors first;" a requirement "that all personal trading be conducted consistent with the code of ethics and in such a manner as to avoid any actual or potential conflicts of interest;" and a fundamental duty on employees not to take "inappropriate advantage of their positions."<sup>135</sup> Second, the Advisory Committee recommended that investment companies make more complete disclosure regarding their trading policies.<sup>136</sup> Third, the recommendations included enforcement mechanisms that largely comported with or extended current practice.<sup>137</sup> Finally, the Advisory Committee recommended

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134. The advisory committee was composed of Charles A. Fiumefreddo, Chairman and CEO of Dean Witter Intercapital Inc., Jon S. Fossel, Chairman and CEO of Oppenheimer Management Group, Robert H. Graham, President, AIM Advisors, Inc., Ronald P. Lynch, Managing Partner, Lord, Abbett & Co., Robert C. Pozen, Managing Director and General Counsel, FMR Corporation, and James S. Riepe, Managing Director, T. Rowe Price Associates. ICI REPORT, *supra* note 16, app. IV.

135. *Id.* at 27.

136. *Id.* at 29.

137. *Id.* at 42-49.

substantive restrictions on personal trading activities that went beyond what was currently mandated by general securities law, the Investment Company Act, the Investment Advisers Act, as well as the prevailing industry practices.<sup>138</sup>

One can approach these recommendations from three perspectives: as management recommendations; as a proposed Code of Best Practices which firms can adopt if they find them useful or if they find it necessary to reassure investors; or as proposed mandatory rules. If viewed as management recommendations, the question is whether these proposals are a sensible way of managing the conflicts of interest faced by access persons in personal trading. To the extent that the proposals are, in fact, mere recommendations which funds are free to adopt or reject, the funds themselves will make this judgment.

More interesting are the questions whether these proposals make sense as an optional Code of Best Practices or as mandatory rules.<sup>139</sup> Because of the tendency of optional Codes of Best Practice to become, in effect, mandatory terms, it makes the most sense to consider whether the ICI proposals would be appropriate recommendations for mandatory rules.<sup>140</sup> To the extent that the ICI's proposals are viewed as proposals for rule making, a striking feature is the extent to which they go beyond correcting any underlying information asymmetry.

From this perspective, only the enhanced disclosure requirements are directly responsive to the information asymmetry. The first proposal—the general statement of fiduciary principles—is more aspirational than regulatory. The remaining proposals—on enforcement and substance—can be viewed as representing two escalating levels of intervention. The more modest of the proposals are the recommendations on enforcement mechanisms which are both consistent with the underlying regulatory structure and current practice, and so raise few significant questions. More interesting, and more controversial, are the substantive proposals which go well beyond, and directly against, the state of the art. It is to these specific proposals that I now turn.

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138. *Id.* at 31.

139. There is a continuum between optional and mandatory, ranging from SEC rulemaking to adoption by funds in order to forestall SEC rulemaking, to adoption by funds out of pressure to conform, or to adoption by funds because they are perceived to be useful, either as a signalling device or as a management approach.

140. The SEC has broad power to issue rules of this sort under § 17(j). *See* 15 U.S.C. § 78(w) (1994).



### A. *Enforcement Recommendations*

In its report, the Advisory Committee recommended that all "codes of ethics require all access persons to 'preclear' personal securities investments."<sup>141</sup> In addition, the Advisory Committee recommended that codes of ethics require direct notification of access person's trades by brokers to the appropriate compliance personnel, duplicate confirmations, and copies of periodic statements for all accounts.<sup>142</sup> The Advisory Committee further proposed that the National Association of Securities Dealers adopt a rule requiring broker-dealers to notify a registered investment adviser when any of its employees opens a brokerage account.<sup>143</sup> Finally, the Advisory Committee recommended that each investment company implement procedures to ensure post-trade monitoring, disclosure of personal holdings, and annual certification of compliance with codes of ethics.<sup>144</sup>

As the earlier summary of the ICI survey results indicated, these recommendations do not go substantially beyond current practice.<sup>145</sup> The core recommendation, namely, preclearance of all trades, while not currently required by rule 17j-1, is nonetheless universally utilized.<sup>146</sup> The other enforcement recommendations supplement preclearance to ensure that codes of ethics are enforced.

The thrust of these recommendations is to increase public confidence by reassuring investors that firms are enforcing their ethics codes. Such steps are consistent with the distinctive underlying structure of the mutual fund regulation: the forcing of explicit contracts, and the enforcement of those contracts, without specifying the terms of such contracts. To the extent that the regulatory strategy depends on firms enforcing their explicit contracts, mandating the adoption of the state of the art enforcement mechanisms is consistent. Moreover, because the recommendations largely track current practice, and, to the extent that they do not, have a limited effect on management discretion or legal trading activities by access persons, they are relatively uncontroversial. Whether they will, in fact, bolster public confidence remains to be seen.

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141. ICI REPORT, *supra* note 16, at 42.

142. *Id.* at 44.

143. *Id.* at 44.

144. *Id.* at 45.

145. See *supra* notes 134-40 and accompanying text.

146. ICI REPORT, *supra* note 16, app. II, at 3.

### *B. Substantive Recommendations*

The Advisory Committee, however, went beyond recommendations that directly respond to the potential asymmetry of information such as the recommendation for increased disclosure, and beyond confidence building measures such as improved enforcement mechanisms. In addition, the Advisory Committee's report contained recommendations for changes to the substantive content of codes of ethics. These changes go well beyond current law and practice. Specifically, the ICI recommended: prohibition of investments in IPOs; restrictions on investments in private placements; blackout periods; a ban on short term trading; and limitations on serving as a director of portfolio companies.<sup>147</sup> I consider each in turn.

#### *1. Initial Public Offerings*

The ICI report recommended that "codes of ethics flatly prohibit investment personnel from acquiring any securities in an initial public offering, in order to preclude any possibility of their profiting improperly from their positions on behalf of an investment company."<sup>148</sup> As the report describes, purchase of IPOs pose two conflicts of interest. First, because the opportunity to participate in a "hot" issue is valuable, it raises the question whether it is a fund opportunity or a personal opportunity. Second, the opportunity to participate in a public offering "may create the impression that future investment decisions for the investment company were not pursued solely because they were in the best interests of the fund's shareholders."<sup>149</sup> That is, the opportunity may be, or may be perceived to be, a bribe.

To the extent that an opportunity to purchase an IPO constitutes a form of payment in exchange for the fund manager purchasing other securities, it is already prohibited by section 17(e)(1), as discussed above.<sup>150</sup> To the extent that the problem is that the opportunity to invest in the IPO is a valuable corporate opportunity, when a fund manager diverts the opportunity to invest to his or her own benefit, it is but a special case of the more general duty of loyalty. This duty is normally analyzed under the rubric of

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147. *Id.* at 31-42.

148. *Id.* at 31.

149. *Id.* at 32.

150. *See supra* notes 35-39 and accompanying text.

"diversion of corporate opportunity."<sup>151</sup>

Corporate law has developed a variety of tests for distinguishing between corporate and personal investment opportunities. However, no per se rule has been adopted, which makes any particular category of investment off limits.<sup>152</sup> Even at the director level, corporate law generally permits disinterested directors to adopt standards for the firm that permit specified recurring types of transactions to be approved in advance, which otherwise might be deemed "corporate opportunities."<sup>153</sup> Below the senior executive level, corporate law has left the problem entirely to individual firms.

The question, then, becomes whether investing in IPOs is somehow so different from other potential corporate opportunities that a mandatory prohibition on all access persons is appropriate. The fact that only twenty-five of ninety-six fund complexes currently forbid *or* restrict such investments is substantial evidence that, as a management matter, the potential for harm to the fund is not such that a mandatory prohibition is required.

Moreover, one can easily imagine situations in which the investment in an IPO is a perfectly legitimate investment. Suppose, for example, that the manager of an S & P 500 index fund seeks to invest in the IPO of a small biotech company. In such cases, the opportunity is clearly not an opportunity of the manager's fund, which is limited to investing in the S & P 500. Similarly, it is likely not a bribe, given the manager's limited investment discretion. As a management matter, one might still consider such an investment opportunity to be an opportunity of the fund complex more generally. In such cases, a fund could adopt a rule like Fidelity's requiring access personnel to offer all "investable" ideas to the funds before investing.

The recommendation for a per se prohibition on investments in IPOs rests, at base, on one of two arguments. First, it may be a sensible political response, independent of whether it is good for funds or shareholders. When, as here, the chairman of the SEC expresses the view that, "were he an investment company director, he 'would have reservations about trading by managers and would be greatly troubled by their buying and selling

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151. For a good discussion of the corporate opportunity doctrine, see ROBERT CLARK, *CORPORATE LAW* 223-62 (1986).

152. *Id.*

153. AMERICAN LAW INST., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 5.09, discussed in John Coffee, Jr., *The Mandatory-Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1670 & n.215 (1989).

IPOs,"<sup>154</sup> banning investments in IPOs may be the better part of valor. But that sensible political response, perhaps necessary to fend off more damaging regulation, should not be confused with a principled regulatory argument.

Second, the recommendation may rest on a claim that participating in a "hot issue" may "create the impression that future investment decisions for the company were not pursued solely because they were in the interests of the fund's shareholders."<sup>155</sup> This argument, is, at heart, an asymmetry of information argument. Like other such arguments, it primarily justifies an information forcing response, namely, the requirement that funds disclose their policies on investments in IPOs in a standardized and comparable form. Without providing evidence that investment in IPOs is undermining confidence in mutual funds, or that a disclosure requirement would not suffice to redress whatever threat to confidence exists, or that prohibiting investments in IPOs will increase confidence, the proposal is unpersuasive.

## 2. *Private Placements*

The ICI Advisory Committee also recommended restricting the investment in private placements by requiring prior approval (taking into account whether the opportunity is a fund opportunity), future disclosure when the manager takes part in an investment decision that affects the investment, and independent review of any such investment decision.<sup>156</sup> Private placements pose a conflict of interest because a fund manager may be given the opportunity to participate in the hopes that down the line he or she will induce the fund to participate in a subsequent IPO, which will increase the value of the manager's earlier investment. The Advisory Committee does not recommend prohibiting such investments entirely—in parallel with investments in IPOs—because "many, if not most, private placements will not raise any potential conflict of interest."<sup>157</sup> A complete ban may solve the conflict but would also restrict many legitimate investment opportunities.

The analysis here follows the analysis of the prohibition on investment in IPOs. As a management recommendation, it departs substantially from current practice. Of the ninety-six funds surveyed, only seven restricted

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154. Arthur Levitt, Chairman, SEC, Remarks at the Mutual Funds and Investment Management Conference (Mar. 21, 1994), *cited and quoted in* ICI REPORT, *supra* note 16, at 32 n.64.

155. ICI REPORT, *supra* note 16, at 32.

156. *Id.* at 33.

157. *Id.* at 34.

private placements.<sup>158</sup> As a political response, it is understandable; Commissioner Roberts noted that he is troubled by "recent press accounts which depict fund managers as receiving free or deeply discounted stock and options in companies prior to fund investment in that company. . . . At a minimum, this type of conduct is troublesome, particularly in an IPO situation."<sup>159</sup> As a principled regulatory response, the recommendation, like the recommendation on IPO investments, is unsupported.

### 3. *Blackout Periods*

The Advisory Committee also recommended that codes of ethics prohibit all access persons from trading on the day during which any fund in the investment complex has a buy or sell order pending, up until the order is executed or withdrawn.<sup>160</sup> In addition, the Advisory Committee recommends that portfolio managers be prohibited from buying or selling a security within at least seven days before or after their investment company.<sup>161</sup> Any trading profits would be disgorged to the fund. While sixty-three of the ninety-six complexes impose blackout periods, they vary in the terms and duration.<sup>162</sup>

The stated justification for blackout periods was that they are necessary to ensure that access persons are not taking advantage of the market effect of fund purchases or sales. As such, the recommendation was designed to improve the enforcement of already existing bans on frontrunning.<sup>163</sup> But, by making it more difficult for access persons to gain any benefit from the market effect of fund trading (whether or not it hurts the fund investors), it made operational the general commitment to putting the interests of the shareholders ahead of the personal interests of the access persons. A blackout period may thus serve as a symbolic commitment that the investment decisions of the funds will be utterly independent of the personal investment decisions of access persons.

At the same time, of course, blackout provisions are overly broad, preventing harmless trading by access persons. Although the prohibition on trading by all access persons before any fund in the complex executes or

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158. *Id.* app. II, at 3.

159. Richard J. Roberts, Commissioner, SEC, Remarks at the D.C. Bar and George Washington Univ. Merging Financial Markets Conference (Mar. 25, 1994), *quoted in* ICI REPORT, *supra* note 16, at 34 n.66.

160. ICI REPORT, *supra* note 16, at 35.

161. *Id.*

162. *Id.* at 36.

163. *Id.* at 36.



withdraws a "buy" or "sell" order imposes little inconvenience, the seven day prohibition on trades by portfolio managers before or after a trade by the manager's fund imposes a more significant restriction. A portfolio manager might complain, for example, that even a very small trade by the fund in a large capitalization company will block personal trades for a two week period, despite the fact that the fund's trade will have no market impact.

As the Advisory Committee pointed out, blackout periods are common, with sixty-three of the ninety-six fund complexes surveyed using some form of blackout period.<sup>164</sup> But, the Committee noted, "there is little uniformity in the duration of blackout periods presently applied—the time periods vary from two to thirty days."<sup>165</sup> The Advisory Committee took this lack of uniformity to be a justification for a uniform recommendation. But should it be? Should one be concerned that blackout periods vary, or that a third of the funds do not use them?

If the blackout periods are largely a mechanism for ensuring that portfolio managers do not benefit from the market impact of fund trading to the detriment of fund investors, then one would expect that the length would vary from firm to firm, depending on the nature of the enforcement problems. Moreover, one should be untroubled by such diversity. If, on the other hand, a prime value of blackout periods is their symbolic reassurance that portfolio managers' trading decisions are unaffected by front running, and, if we assume that investors will not be able to distinguish between firms with good and bad blackout policies, then a uniform standard may be important. On this analysis, blackout periods, like preclearance, are important mechanisms for enforcing the ban on front running and other variants, and uniformity is valuable for building investor confidence.

#### *4. Ban on Short-Term Trading Profits*

The Advisory Committee's most controversial proposal was its recommendation that "codes of ethics prohibit all investment personnel from profiting in the purchase and sale, or sale and purchase, of the same (or equivalent) securities within 60 calendar days."<sup>166</sup> This proposal departed dramatically from current practice: only four of ninety-six funds

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164. ICI REPORT, *supra* note 16, at 36.

165. *Id.*

166. *Id.* at 37.

surveyed prohibited such trading.<sup>167</sup> The stated justification was that such a prohibition "can serve as an important prophylactic device against potential frontrunning transactions."<sup>168</sup> The Committee itself recognized that, as a response to frontrunning, the recommendation could be viewed as "overkill." Indeed, the proposal—which all but eliminates options trading and short selling<sup>169</sup>—holds the greatest potential for driving money managers to less regulated collective investment vehicles.

Why is it that so few investment companies currently prohibit short term trading? Here, the arguments made above in connection with personal trading generally re-enter. On the one hand, short term trading is potentially a problem because it can distract an access person from his or her job. In addition, it is one method by which access persons can capitalize on the market effect of fund trading.

On the other hand, firms have good incentives to adopt an optimal policy on short term trading. If, in fact, it is unduly distracting, a firm can prohibit it or fire the access person who is spending all day on the phone with his or her broker. At the same time, some of the people whom a fund most wants to hire are going to be avid traders. If funds individually or collectively ban short term trading, these traders may well choose one of the less regulated alternatives.

The arguments against a ban on short term trading thus parallel the arguments that the Advisory Committee itself made in rejecting the suggestion that all personal trading be banned.<sup>170</sup> What, then, is the attraction of such a policy, and why would the Advisory Committee's recommendation for enhanced disclosure not suffice? One explanation for the recommendation, like the explanations for other substantive recommendations, may be political: Congress and others periodically condemn short term trading as "speculative." As such, the recommendation has the virtue of being politically wholesome, even if it proves harmful to mutual fund investors by driving away some of the best stock pickers.

##### *5. Access Persons Serving as Directors*

Finally, the Advisory Group recommended that "codes of ethics prohibit investment personnel from serving on the boards of directors of publicly

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167. Of these four, two impose a 30-day holding period, one a 60-day holding period and one a 91-day holding period. *Id.* at 38.

168. ICI REPORT, *supra* note 16, at 37-38.

169. *Id.* at 39 n.72.

170. *Id.* at 19-25.

traded companies, absent prior authorization based upon a determination that the board service would be consistent with the interests of the investment company and its shareholders.”<sup>171</sup> While a recommendation that access persons not serve as directors absent advance approval by the fund is unexceptional, what is most striking about the recommendation (which, of course, has nothing to do with personal trading) is what it reflects about the industry’s attitudes towards involvement in the governance of portfolio companies. Although mutual funds are among the biggest shareholders, the industry clearly does not believe that involvement in portfolio companies pays, or that it pays sufficiently well to forego any liquidity. This is reflected in the Advisory Committee’s comment that “[i]n the relatively small number of instances in which board service is authorized,” a Chinese Wall procedure should be used to shield directors from investment decisions.<sup>172</sup> This view should stand as a warning of the magnitude of the task of those who would cast mutual funds as “relational investors” who might provide continuous and textured monitoring through a position on the board.

### C. Conclusion

As described above, the Advisory Committee goes substantially beyond attempting to redress the information asymmetry that lies at the heart of the concern with market integrity. One lesson that emerges from the analysis is that once one moves beyond measures designed to improve disclosure to non-disclosure based measures that may be thought to increase consumer confidence directly, the scope for responding to political pressures increases substantially. The Advisory Committee’s recommendations to ban investment in IPOs, to limit investments in private placements, and to prohibit short term trading are perhaps best explained as responses to such pressure.

## V. THE DIVISION OF INVESTMENT MANAGEMENT’S REPORT AND RECOMMENDATIONS

Several months after the ICI commission’s report and recommendations, the SEC’s Division of Investment Management issued its own report and recommendations.<sup>173</sup> Following a review of thirty fund groups employing

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171. *Id.* at 40.

172. *Id.*

173. SEC REPORT, *supra* note 17.

622 fund managers who, in aggregate, managed 1,053 funds with total assets of \$521 billion, the Division concluded that fund managers generally did not invest extensively for their personal accounts and that potential conflicts of interest were few.<sup>174</sup> Taken as a whole, the Division concluded that the data collected suggested "that the existing regulatory framework governing the personal investment activities of fund personnel has generally worked well, but can be improved. The data, in any event, does not reveal abusive trading patterns that the Division believes could only be remedied by a total prohibition on personal trading by fund personnel."<sup>175</sup>

Given the media attention to personal trading, the data collected by the Division on trading patterns is striking: in 1993, 43.5% of the fund managers in the sample did not trade at all and 75% had ten or fewer transactions.<sup>176</sup> A few managers associated with fund groups selected on the basis of staff experience that indicated active trading by managers, accounted for the large majority of trades and the large majority of matching trades.<sup>177</sup> In all but a very few cases of matching trades, the funds received better prices than the managers,<sup>178</sup> with the fund manager receiving a better price in only about one percent of the transactions.<sup>179</sup>

The SEC Report, like the ICI Report, rejected a *per se* ban on personal trading. First, the Division raised some doubts about the SEC's authority to ban personal trading, and pointed out that the language and legislative history of section 17(j) does not contemplate a complete ban, but, rather, recommends regulation.<sup>180</sup> Second, in the absence of any evidence of widespread abuse, the Division did not believe that the "potential harm to fund shareholders resulting from the practice [was] so great as to be contrary to the public interest."<sup>181</sup>

In place of a ban on personal trading, the Division made two types of recommendations. First, although the Division did not recommend the adoption of the ICI recommendations as SEC rules, it gestured in that direction:

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174. *Id.* at 18.

175. *Id.* at 2.

176. *Id.* at 18.

177. Matching trades are "defined to include any personal transaction that preceded by ten days or less a transaction by a related fund on the same side of the market (i.e., buy/buy or sell/sell) in the same or related securities." SEC REPORT, *supra* note 17, at 18.

178. *Id.* at 24.

179. *Id.*

180. *Id.* at 27-28. See also *supra* note 177 and accompanying text.

181. SEC REPORT, *supra* note 17, at 28.

[T]he Division believes that the management and board of directors or trustees of each fund should specifically consider the recommendations in the ICI Report. Moreover, the Division would expect all funds to adopt the Report's recommendations, in whole or substantial part, absent special circumstances.<sup>182</sup>

In case anyone did not get the message, the Division went on:

[The Division] request[s] a report from the ICI within the next six months describing, among other things, the number of ICI members that have adopted the recommendations and any interpretive, administrative, or other problems ICI members have experienced in implementing the recommendations. On the basis of that report, the Division may reconsider the issue of amending rule 17j-1 to provide for uniform code of ethics standards.<sup>183</sup>

Second, the Division made several specific recommendations including: disclosure by funds of personal investing policies; enhanced board review; disclosure of pre-employment holdings of fund employees; a National Association of Securities Dealers ("NASD") rule requiring that brokers notify funds whenever a fund employee opens a brokerage account and, at the request of the fund or adviser, that brokers provide duplicate copies of confirmations and account statements; a ban on participation of access personnel in "hot issue" public offerings; and clarification that section 17(j) applies to financial instruments other than securities such as futures and commodities.<sup>184</sup>

With one exception, the Division's recommendations fall comfortably within the two types of regulations that can be justified by the underlying asymmetry of information that gives rise to the market integrity worry.<sup>185</sup> With respect to disclosure, the Division recommended that funds be required to disclose personal investing policies briefly in the prospectus and to describe the manner in which an investor can obtain a copy of the fund's code of ethics.<sup>186</sup> In addition, the Division recommended that the SEC require funds to attach a copy of their code of ethics as an exhibit to the registration statement, in effect returning to the prior practice,<sup>187</sup> and

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182. *Id.* at 32.

183. *Id.*

184. *Id.* at 33-37.

185. The Division's recommendations are substantially more modest than the ICI recommendations, but must be considered against the strong pressure on funds to adopt those recommendations "voluntarily." Compare *id.* with ICI REPORT, *supra* note 16, at 26-50.

186. SEC REPORT, *supra* note 17, at 33.

187. *Id.*



thereby making ethics codes generally available. This enhanced disclosure would address the asymmetry of information directly, by including the substance of policies in the prospectus, and indirectly, by making available information that third parties (the press, analysts, academics) could digest and publicize.

The Division's recommendations regarding the disclosure to funds of employees' pre-employment holdings<sup>188</sup> and its recommendation that the NASD adopt a rule requiring brokers to notify funds directly of brokerage activity by fund employees<sup>189</sup> both relate to sharpening the "enforcement technology" available to funds. As with the ICI's recommendations regarding preclearance of trades, these recommendations do not go to the substance of a funds' personal trading policy, but, rather, can be expected to increase investor confidence by making the enforcement of fund policies more effective. Although the recommendation goes beyond current practices (only one of the funds' studied by the SEC required new employees to disclose securities holdings), it was calculated to sharpen the funds' ability to enforce their ethics codes without dictating substantive norms.

The Division's recommendation of enhanced board review, according to which the Division proposed to amend rule 17j-1 to require an annual review of codes of ethics by the board, can likewise be viewed, in part, as an attempt to make the enforcement of ethics codes more effective. Consistent with this goal is the recommendation that the board examine "whether both the fund and its adviser (and any subadvisers) have adopted appropriate measures designed to prevent and detect abusive investment practices and whether they have instituted effective compliance procedures."<sup>190</sup> At the same time, the Division's recommendation can be viewed as an attempt, like the ethics codes themselves, to force funds to choose a personal trading policy explicitly. Thus, the Division recommended that, in the first instance, the board should determine "whether personal investing is consistent with the interests of the fund's shareholders and should be permitted."<sup>191</sup>

The one Division recommendation that goes beyond the scope of the

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188. SEC REPORT, *supra* note 17, at 35. The Division's recommendation on the disclosure of pre-employment holdings advises "that rule 17j-1 be amended to require each access person of a fund to disclose his personal securities holdings at the time at which the access person is first employed by the fund or its investment adviser." *Id.* As the Division points out, a fund cannot police conflicts of interest without knowing the composition of employees' personal investment portfolios. *Id.*

189. *Id.* at 35.

190. *Id.* at 34.

191. *Id.*

underlying regulatory justification is the recommended ban on participating in "hot issue" public offerings. While the ICI recommended a total ban on purchases of IPOs, the Division, concerned that the SEC's authority under section 17(j) may not be sufficiently broad, recommended that the NASD consider extending the existing ban on sales of hot issues to broker-dealer employees to "personnel of investment companies, investment advisory firms, banks, savings and loans, and insurance companies who have authority to direct business to NASD members."<sup>192</sup> This recommendation, like the ICI's broader recommendation, goes beyond disclosure and enforcement technology to attempt to address directly an "appearance of impropriety." As such, it is an ad hoc attempt to bolster investor confidence. Here, as in the ICI's report, the best explanation for the recommendation may be the fact that, as the Division's report notes, "Chairman Levitt . . . [has] expressed concern that participation by access persons in IPOs, especially 'hot issue' IPOs, creates the potential for troublesome conflicts of interest."<sup>193</sup>

The SEC's Report, in combination with the ICI Advisory Committee report, seems to have had several effects. First, the mutual fund industry seems to have fallen in line. According to the follow up report that the Division of Investment Management requested from the ICI, an overwhelming majority of ICI members have adopted or adapted some or all of the recommendations, as summarized in Table 1.<sup>194</sup>

RECOMMENDATION	COMPLEXES		COMPLEXES	
	ADOPTING	ASSETS	ADAPTING	ASSETS
General Principles	82%	88%	6%	8%
IPOs	72	64	14	30
Private Placements	69	70	14	26

192. SEC REPORT, *supra* note 17, at 36.

193. *Id.* at 36 (citation omitted).

194. INVESTMENT CO. INST., REPORT TO THE DIVISION OF INVESTMENT MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION: IMPLEMENTATION OF THE INSTITUTE'S RECOMMENDATIONS ON PERSONAL INVESTING (Apr. 21, 1995).

RECOMMENDATION	COMPLEXES ADOPTING	ASSETS	COMPLEXES ADAPTING	ASSETS
Blackout periods	53	47	35	48
Ban on Short Term Trading	47	65	23	29
Service as Director	66	72	16	23
Preclearance	69	81	14	14
Record keeping	70	83	14	12
Post Trade Monitoring	84	90	16	10
Disclosure of Personal Holdings	66	80	11	12

Note that with respect to the most controversial of the recommendations, the ban on short term trading, it has only been adopted by forty-seven percent of the member complexes, which hold sixty-five percent of the assets.<sup>195</sup> An additional twenty-three percent of the complexes with twenty-nine percent of the assets stated that they adapted the ban to their particular circumstances, with some adopting a more stringent version.<sup>196</sup> In view of the uneven distribution of trading activity by access personnel found in the SEC Report, this suggests that the proposal has so far been adopted largely by those funds in which little trading occurs. This is consistent with the informal impression of people in the industry. Second, Congress seems satisfied and has moved on to other issues. Finally, the media has likewise found other things to worry about.

#### CONCLUSION: LESSONS TO BE LEARNED

The personal trading controversy presents a classic event in securities

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195. *Id.* at 21.

196. *Id.*

regulation. A practice emerges which captures public attention, at least briefly. Arguments for and against the practice are made. For a complex variety of political and economic reasons, the regulators feel an imperative to act and the industry feels an imperative to take preemptive action. The pro-regulatory forces suggest that the practice at issue threatens investor confidence and the integrity of the capital markets. The anti-regulatory forces argue that the market can provide any necessary corrections. This constellation of forces repeats itself: insider trading; personal trading; and the use of financial derivatives, to name just a few of the more recent examples.

The personal trading controversy points to several critical features that apply more generally. First, this controversy, like many others of its type, is not primarily about fund performance. To the extent that one worries about the impact of personal trading by fund managers on the performance of their funds, product markets that are as competitive as the market for mutual funds and money management services provide firms with strong incentives to adopt optimal personal trading policies. Thus, the controversy is about "market integrity" and "investor confidence".

This leads to the second important lesson that we can draw from the controversy. The foregoing analysis of the controversy sharpens our understanding of the nature of the "market integrity/investor confidence" argument. At its heart, it is a claim about asymmetric information and costly signalling. Equally important, this analysis provides a principled basis for regulatory intervention as well as principled limits on that intervention. If my analysis is correct, then the "market integrity/investor confidence" argument may be a valid claim, depending on the facts. However, when regulatory initiatives go beyond addressing the underlying asymmetry of information or reducing the costs for industry participants to signal integrity credibly and instead attempt directly to bolster "investor confidence" by enjoining particular practices that create an appearance of impropriety, the initiatives will be ad hoc. This imposes a greater burden on proponents to establish that the regulations will, on balance, actually benefit investors.

Third, the personal trading controversy provides a vivid illustration of the interplay between media attention, congressional attention, SEC inquiry, and pre-emptive industry self regulation. Here, the ICI's advisory committee adopted recommendations that, if adopted, would significantly change the substantive terms of firm trading policies. The SEC's Division of Investment Management, while adopting narrower recommendations, also sent a strong signal that, unless the industry "got with the program,"

stronger stuff was on its way. In response, the industry fell in line.

Finally, the fairly unique regulatory structure in place in the mutual fund area, in which a narrow set of mandatory rules are supplemented by a regime of forced explicit contracting, provides a promising and important middle ground between the regulatory and deregulatory camps and deserves wider scrutiny and use. This is the only sort of regulatory approach that stands a chance of working, given the incredible diversity among firms that manage so much of our money.